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HOW DID MP 579 IMPACT OUR PORTFOLIO

Much has been written on the MP 579, which has brought significant changes to the electricity sector. Our job as managers is to analyze these changes and re-evaluate the risk-return relation of our investments, adjusting our allocation between companies and sector if necessary.

The fact is that these changes brought negative surprises for investors and companies within the sector, including energy generation companies (our main investment focus). Some changes worth mentioning: (i) significant price reduction in the regulated market, above general expectations – MP 579 refers to tariffs (instead of prices) based on operational and maintenance costs determined by Aneel (the National Electricity Energy Agency), resulting in a decrease of around 70% in prices. (ii) energy generation companies that have just renewed concessions for the second time are required to sell energy in the regulated market (i.e. to the distribution companies that on their turn will resell this energy to their own clients). This can create an imbalance in energy prices sold in the regulated and the free market, raising great uncertainty. (iii) an ambiguous passage in this legislation has led to the interpretation that even companies which have never renewed concessions are also subject to these rules, forcing them to sell energy prices below initial agreements. Today the general understanding is that these regulatory changes will only affect energy generation companies with concessions ending between 2015 and 2017. Nonetheless, this matter has not been fully confirmed by the government.

The concession contracts of the three investments we have in the sector (AES Tietê, Tractebel and Energias do Brasil) are not directly affected by these regulatory changes. In spite of this, since energy is being redirected to the regulated market with capped tariffs (significantly lower than those charged in the free market), future energy prices are now subject to great uncertainty, leading to poorer predictions on future cash flows. Furthermore, these regulatory changes suggest that the federal government wants to exercise more control over energy prices. On the long run, this represents lower profitability for companies within the sector. Our preference for energy generation companies was based on the thesis that they had lower exposure to regulatory and political intervention than distribution and transmission companies.

As depicted above, we are less confident on this sector's expected returns (adjusted to risk) and therefore we have been reducing our exposure to it. Our allocation to the industry was about 20% of the portfolio in the end of August and by the end of December we had already reduced it to approximately 15%. More recently, increased uncertainties caused by low hydroelectric reservoirs water levels, has motivated us to reduce our exposure even further.

MP 579 AND THE CONFLICT OF INTERESTS IN STATE-OWNED COMPANIES

We have chosen this topic due to discussions involving new rules for the renewal of concessions of companies from the electricity sector. Specifically in the case of Eletrobrás, the renewal was approved by a General Meeting with a favourable vote of the Brazilian government, the company's controlling shareholder, despite a formal request presented by a group of minority shareholders arguing the government's vote should be disregarded given the presence of a conflict of interest. They claimed that this conflict resulted from the fact that the government itself had issued the norms that would ultimately have a negative impact on the company's cash flow.

The question remains: is the Brazilian government in this case voting against the interests of the company or rather favouring its own benefit? (Brazilian Corporate Law, Article 155, Paragraph 1)

When we analyse the corporate governance standards of companies in our universe, we try to understand the following factors (i) which are the interests of the controlling shareholder (those being of an economic nature or not), (ii) if there are any potential conflicts with the interests of minority shareholders, (iii) if those conflicts can be mitigated by corporate or legal measures and (iv) which is the potential loss in case decisions unfavourable to this group are approved.

The answers to these questions are the main pillars for our philosophy of not investing in state-owned companies. We believe the interest of the government (a public interest) differs in many aspects from the interest of minority shareholders (more concerned with the share price appreciation). However, as we are going to argue, this misalignment on its own is not enough to remove from the controlling shareholder his voting rights.

The Brazilian Corporations Law clearly establishes that state-owned companies should be governed according to public interests. Eventual economic losses deriving from decisions taken following this rationale are hard to be measured since they will likely involve a political perspective rather than financial aspects.

To understand if there is at all a conflict of interests when the government votes in such situations, one should first understand which is the interest pursued by state-owned companies. Under the Brazilian legal system, such companies should be governed according to two distinct interests: the economic interest of seeking profits and the public interest. The latter is further classified by academics in another two sub-categories: (1) the primary public interest, which aims the benefit of society as a whole, and (2) the secondary public interest, more concerned with the economic benefit of the State. According to the law, only the first can be considered an objective of state-owned companies.

Article 238 of the Brazilian Corporate Law (Law 6404/74) establishes that the controlling shareholder of a state-owned company has the same duties and responsibilities of any other controlling shareholder. It allows however such shareholder to direct the company's activities to the achievement of the public interest that underpinned its creation. Hence, the law imposes (even if the word used is "allows" we see it as an obligation) greater duties and responsibilities to the State as a controller than to private owners. Not only has the State to act for the benefit of other shareholders and related third-parties (e.g. employees and suppliers), but it also has to direct its controlling power for the pursuit of collective interests.

Thus, state-owned companies were created to develop activities aiming to benefit all society's members in an efficient manner, but with no commitment of any sort in relation to the maximization of profits. In fact, they should aim to implement their objectives balancing both results. Nevertheless, such companies shouldn't overlook their main target, which is to provide their services in a continuous way, reaching the greatest number of people, while charging moderate tariffs. Under the Brazilian legal system, there is no way a state-owned company could have its activities exclusively market-driven and ignore its main singularity, namely: the pursuit of the public interest.

Based on the above, it is reasonable to advocate that when the government votes in a General Meeting on a matter related to the public interest (in the specific case of Eletrobrás, the reduction of electricity tariffs), it is not disregarding its fiduciary duties. In fact, there is no conflict of interest with the company itself, but rather with the remaining shareholders. In this sense, the law only prevents the controlling shareholder to vote when the former is observed, not the latter. As far as Eletrobrás is concerned, clearly both the company and the government were pursuing a common objective, even if ultimately their decision would result in a negative impact to the company's revenues. One could go even further and claim that, had the government refrained from voting, this could actually be considered an omission, since the government is expected to always place the public interest above private concerns related to profitability.

It is worth pointing out that we are not trying here to defend the Brazilian model. There are actually some countries where state-owned companies have no public duty whatsoever. In fact, we believe the Brazilian system discourages private players from investing in public companies. Nonetheless, as asset managers, we work with the variables that we are given, including the legal system. That is why it has always been clear for us that the incentives and interests driving state-owned companies are not compatible with our investment philosophy.

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